VZCZCXRO1289
RR RUEHAG RUEHAST RUEHDA RUEHDBU RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA
RUEHLN RUEHLZ RUEHNP RUEHPOD RUEHROV RUEHSK RUEHSR RUEHVK RUEHYG
DE RUEHVJ #0589/01 1311400
ZNR UUUUU ZZH
R 111400Z MAY 09
FM AMEMBASSY SARAJEVO
TO RUEHC/SECSTATE WASHDC 0192
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 03 SARAJEVO 000589

SIPDIS

TREASURY FOR LINDQUIST

E.O. 12958: N/A
TAGS: ECON EFIN EAID BK
SUBJECT: BOSNIA: HARSH ECONOMIC TIMES LEAD TO STANDBY
ARRANGEMENT WITH IMF

REF: A. SARAJEVO 575
¶B. SARAJEVO 241
¶C. 08 SARAJEVO 1662

¶1. Summary. The International Monetary Fund (IMF) on May 5 announced it had reached a staff level agreement on a $1.52 billion standby arrangement with Bosnian authorities. This is the first such agreement since the last one expired in 2004, and reflects Bosnia,s growing concern with its deteriorating fiscal situation (much of it self-inflicted). Both entities will have to rebalance their budgets and find deep spending cuts (415 million KM in the Federation, 146 million KM in the Republika Srpska (RS). The state will also find 40 million KM in cuts, but refused RS demands) correctly in our judgment - to rebalance its FY09 budget (which would have cut its share of revenues from the Single Account and effectively lowered the starting point for FY10 budget negotiations). Brcko District will also find 10 million KM in cuts. The agreement is subject to approval by the IMF governing board, (likely in early July) and is dependent upon BiH,s fulfillment of three things prior to disbursement: the rebalancing of the entity budgets, the adoption of an excise law, and the adoption of a budget framework. End Summary.

¶2. Following two weeks of IMF consultations in BiH, on May 5 an agreement was reached on a $1.52 billion, 3-year standby agreement (approximately 2.35 billion convertible marks (KM), the local currency). This is the first such agreement since the last one expired in 2004 and negotiations to reach a new one failed in 2004 and 2005. That a deal was struck at all highlights entity concerns with their deteriorating fiscal positions (Refs A and B). Two-thirds of the loan will go to the Federation entity budget, and one-third to the Republika Srpska (RS) entity budget. The state will not receive any IMF money. Both entities in serious fiscal trouble (in large part, but not exclusively, due to overly generous transfer payments), with estimates of a 1.2 billion KM deficit in the Federation and a 1 billion KM deficit in the RS. In return for the agreement, both entities agreed to rebalance their FY09 budgets.

Condition One: Budget Cuts

¶3. The agreement requires the state and entity governments to find savings in their FY09 budgets. The Federation agreed to 414 million KM in cuts (approximately 200m KM from the entity budget, the rest from the cantons and municipalities), the RS agreed to 146 million KM, and the state, 40 million KM. These cuts must be found prior to disbursement of the first tranche of funds, which could come as early as July if the IMF governing board approves the agreement. The Federation is already drafting a law to cut government salaries across the board by 10%, and social transfers to all categories of war victims and veterans by 10%. This will make for an

interesting Parliamentary session at the end of May, particularly since the Federation has been overly generous with its social payments and refuses to stand up to its increasingly demanding war victims and veterans. Eyes are already turning to the 2010 national elections, and politicians will be wary of disappointing such important, vocal constituencies.

¶4. The RS intends to cut 70 million KM (or just under half of its required cuts of 146 million KM) from the entity budget; the rest will come from cuts to municipal budgets. (Note: Undercutting municipal budgets allows the RS to target its political opponents at the local level. It is also unfortunate to cut at the municipal level since municipalities provide the most services to RS citizens. End note). The RS plans to meet its target by reducing the salaries of the highest paid civil servants by 10%, lowering allowances such as per diem, and adopting a hiring freeze. It will also introduce structural reforms in its social payments by streamlining eligibility criteria and improving targeting (Comment: The RS, with USAID assistance, has reformed and modernized its social contribution payment system. This will significantly improve the RS's ability to ensure that companies comply with laws and regulations, increase entity revenues and help to identify those in arrears or ineligible for benefits. The same assistance has been offered to the Federation, but the Federation Parliament has repeatedly delayed the passage of laws to implement the reforms and the tax administration has resisted implementation of the supporting IT system. End Comment).

¶5. Brcko District and the state agreed to share the fiscal burden by finding 10 million KM and 40 million KM

respectively in savings from their current budgest. The state plans to meet this target by reducing government employees, benefit packages, cutting spending on items such as meal and vacation allowances. The RS initially insisted that the state rebalance its budget as well. This would imply a reduction of revenue to the state from its major revenue source, the Single Account (made up of VAT and other customs receipts and shared between the entities, Brcko and the state). It would also effectively lower the starting point for FY10 budget negotiations. This would affect the state negatively (an RS objective) just when it needs to create new and strengthen existing institutions in order to move toward EU accession. State Finance Minister Dragan Vrankic dug in his heels, however, and refused to agree to the arrangement if it required the state to rebalance. The IMF confirmed that it would not require the state, with its relatively good fiscal condition, to rebalance. Rather than scuttle the entire deal, the members of the National Fiscal Council (composed of both state and entity Finance Ministers and Prime Ministers), finally agreed to the arrangement without a rebalancing of the state budget.

Condition Two: Law on Excise Taxes

¶6. In addition to cutting expenditures, BiH must improve its fiscal picture by increasing revenues. A Law on Excise Taxes, which will raise excises on tobacco, coffee and petroleum products (and eliminate dual taxation for imported raw materials which are finished in BiH), has been in limbo for two years. The IMF visit has created the impetus for it to finally enter into Parliamentary procedure. The draft law recently passed the first reading at the BiH Parliament and is on track to be passed by July, which is required in order to receive the first tranche of IMF funding.

Condition Three: Adoption of a Macroeconomic Framework

¶7. Bosnia has agreed to adopt a &Framework of Fiscal Balance and Policies in BiH8 before the first loan tranche can be

disbursed, and by the first review in the fall of 2009 develop the macroeconomic parameters that will provide the basis for the preparation of 2010 state and entity budgets. BiH also plans on setting up procedures for improved multi-year budgeting. Comment: The adoption of a budgetary framework to provide the basis for yearly budgets was also a goal of the National Fiscal Council (NFC) Law passed last year. However, the law provides no mechanism to deal with noncompliance by budget users, and therefore is essentially toothless. We suspect any framework developed for the IMF will suffer a similar fate. End Comment.

In Other Good News

¶8. The Federation government has also agreed to create an action plan, with assistance from the World Bank, to reform its system of transfer payments for war victims and veterans. The system currently suffers from bloated recipient rolls and other serious structural defects. As with the budget framework, we suspect this will amount to a lot of talk but little action. War veterans and victims groups are extremely large, vocal constituencies and have been known to punish politicians at the ballot box who attempt to cut benefits. With elections coming in 2010, the political will to make the kind of changes needed will be in short supply.

¶9. In a meeting with the Vice Governor of the Central Bank of BiH, Ljubisa Vladusic, USAID was told that as part of the IMF standby, the BiH authorities also committed to approve a state guarantee for the EBRD Stand-By Facility no later than the end of June 2009. This will enable the release of EUR 50 million in support of the Deposit Insurance Agency (DIA) Reserve Fund (Ref C). Currently the Department of Treasury is assisting with the legislation required to legalize the state guarantee.

Is It Enough?

¶10. If approved by the IMF Governing Board, BiH will be able to draw the first tranche of USD 266 million (approximately 390 million KM) by July. A second tranche worth USD 226 million (approx 331 million KM) will be available in December, and a third for USD 33 million (approx 48 million KM) will be made available in March 2010. The IMF estimated that the consolidated budget deficit in the Federation is around 1.2 billion KM, and in the RS, around 980 million KM.

IMF funding alone will not be enough to cover them. Both entities plan to use the first tranche to service foreign debt. The Federation had earlier this year negotiated 154 million KM in commercial loans (but has yet to receive any money), and got an unwelcome surprise when it learned that the IMF loan could not be used to repay it. It now hopes to negotiate some kind of budget support loan from the World Bank or other International Financial Institutions (IFIs). The RS has yet to comment on its staggering debt, and to the contrary, continues to extol the virtues of the RS fiscal situation vis-a-vis the Federation,s (Ref A). The IMF visit has proven otherwise.

Comment

¶11. Both the Federation and the RS need this loan desperately. This is evident from the budget cuts both are willing to make, as well as the RS decision to back off on its demand that the state rebalance its budget. But do they need it enough to overcome the political opposition that will arise when they try to cut transfer payments, salaries, and other compensation to workers? That these issues are on the table is a big step in itself, but we cannot be sure the Federation or the RS (but the Federation in particular) can sustain the political will to turn words into action. It is possible that the state, the Federation and the RS will

fulfill the three conditions in order to draw a first tranche in July, but as often happens in BiH, new legislation, action plans and budget frameworks are likely to stall at the implementation phase. End Comment.
ENGLISH